A New Capital Regulation for Large Financial Institutions

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The views expressed in this presentation are those of the author and do not necessarily represent those of the *IMF*.

A Costly Time Inconsistency

- Individual MH: Too Big To Fail
  - If there was any doubt …
  - Distortionary: Advantage for larger institutions

- Collective MH: Macro Bailout (Fahri and Tirole, 2009)
  - Incentive to correlate on risks that depend on simple macro variables (object of non-targeted bailouts):
    - Housing market in the U.S. (monetary easing/Fannie-Freddie)
    - Exchange rate stability in Eastern Europe (IMF/EU support for pegs)

- Crises are expensive. This one in particular:
  - Direct fiscal cost (net of recovery): 2.8% of GDP
  - Increase in public debt to GDP: almost 40%
  - Cumulative output loss in crisis G-20: 30% of GDP

Need for Improved Regulation

- Prompt corrective action:
  - Costly regulatory framework
  - Necessarily limited to subset of financial institutions
  - Subject to regulatory capture
  - Lacks solid legal backing for early intervention
  - → Too little, too late
- No commitment device to force even partial default

Hart-Zingales Proposal

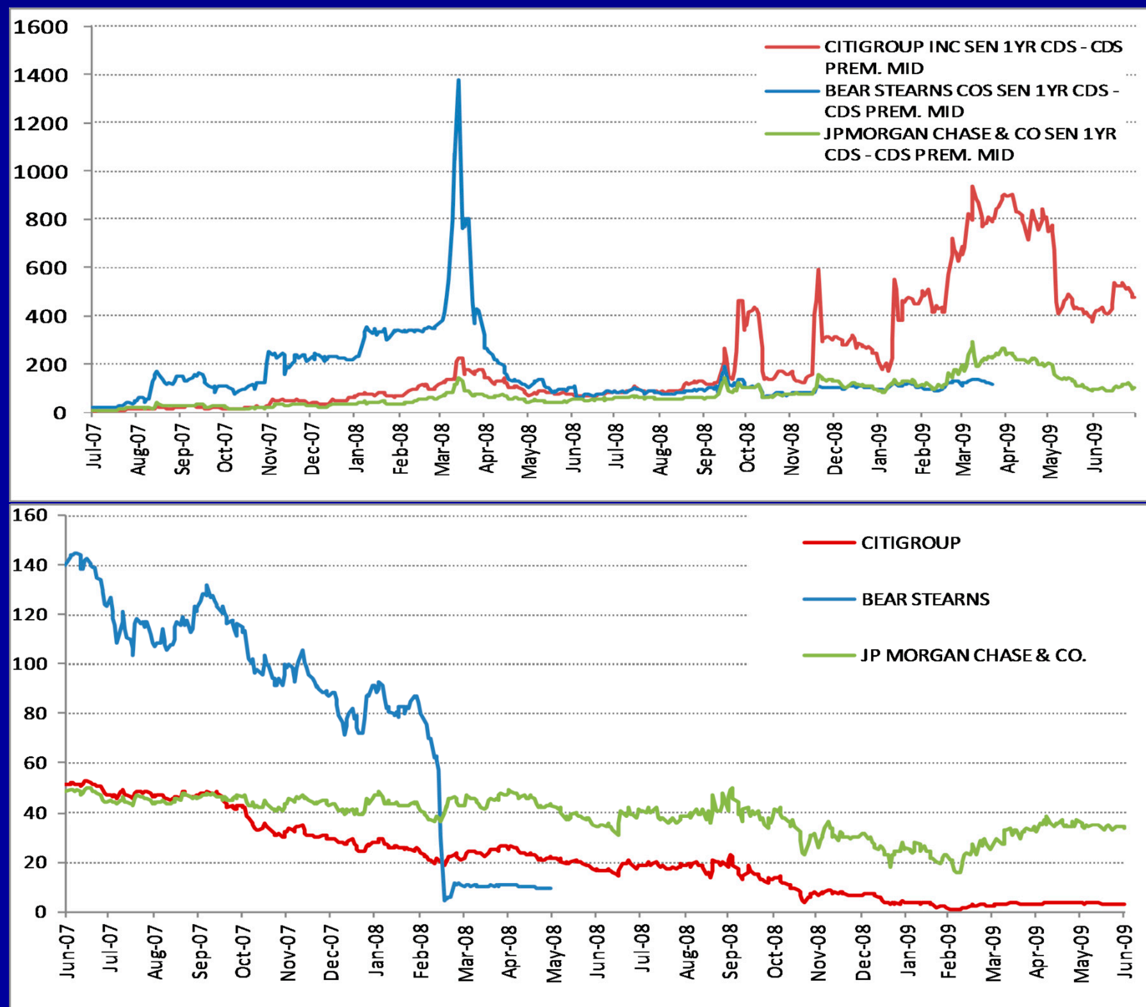
- Target large financial institutions
- Use CDS price as signal to determine distress
- Avoid default by requiring banks to raise capital when their CDS>threshold
- Regulatory intervention in case recapitalization fails
- Regulator places bank in receivership if debt is at risk
  - Wipe out shareholders
  - Haircut on junior debt to support CDS market

Many Benefits

- Moves the fence away from the cliff
  - CDS can trigger intervention before capital is depleted
  - Equity issuance still feasible
- Relies on market data (cheap)
  - Can be applied to unregulated institutions
  - Costly inspection only for those unable to raise equity
  - Broader umbrella at low cost
- Improves political economy of intervention
  - Gives greater powers for early intervention to regulator
  - Makes forbearance more difficult – reduces capture
  - Commitment device to force default (?)

Some Questions

- Are CDS more forward looking than equity?
  - Is equity issuance an option once CDS spreads widen?



Some Questions

- Should not regulators know better than the market?
  - Benefit from this point of view limited to political economy
  - Yet, implicit government guarantees difficult to rule out
  - CDS market will reflect these expectations
- How do CDS spreads change once this policy is in place?
  - Timing in model different from policy proposal
  - Does this matter? (triggering reduces prob. of default)
  - Are there parameters values for which this is a problem?

Some Questions

- Proposal reduces cost of borrowing and increases cost of equity:
  - Systemic liabilities more protected
  - Option value of equity in a crisis reduced
  - Greater incentives for leverage?

- How does it apply to systemic crises?
  - Does not address "macro bailouts"
  - Regulator reluctant to force equity issuance
  - Risk of deleveraging spirals
  - CDS market can become itself distorted by counterparty risk